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No. 85-512

In the Supreme Court of the United States

OCTOBER TERM, 1985

RICHARD H. FOSTER, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

This income tax case concerns the tax ramifications of petitioners' development of Foster City, California. The many issues raised in the petition turn on the facts and circumstances involved, and were correctly decided in the Commissioner's favor by the courts below. There is no conflict among the circuits or other consideration warranting this Court's review.

1. Jack Foster and his three sons did business as a partnership (Pet. App. II, at 1-2).[1] The partnership purchased a barren and partially submerged tract of 2,600 acres in the San Francisco Bay area, reclaimed and developed it with

[1]Petitioners' wives are parties to this case solely by virtue of having filed joint income tax returns with their husbands for the relevant tax years. Jack Foster died after the period in suit and his estate has been substituted as a party.

the aid of a quasi-public improvement agency that the partnership controlled, and marketed the improved lots for residential and commercial uses (Pet. App. II, at 1-3, 15-17; Pet. App. III, at 74-77). The area is known as Foster City and has 35,000 residents. Petitioners' role in the creation of Foster City gave rise to the two principal issues in this case.

a. After improving certain of the lots in "Neighborhoods" One and Four of Foster City, the partnership transferred them to five corporations that petitioners controlled (Pet. App. II, at 7-8). Four of the corporations, known collectively as "the Alphabets," were newly formed to take title to the properties; the fifth, Foster Enterprises, had been incorporated several years earlier and had an accumulated net operating loss of more than $1 million (*ibid.*). The transfers of land to these corporations were "nonrecognition" transactions, *i.e.*, neither the partnership nor the transferees recognized gain (or loss), and the partnership's original cost basis in the lots, which were highly appreciated, carried over to the transferees. See Sections 351 and 362.[2] The Alphabets and Foster Enterprises sold the tracts to third parties, and reported the income from the sales on their tax returns (Pet. App. III, at 56, 102). Foster Enterprises used its preexisting net operating loss to offset its gain from the sales (*id.* at 104-105).

Section 482 of the Code authorizes the Commissioner to "allocate gross income, [or] deductions" between or among businesses that are controlled by the same interests, "if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such * * * businesses." Pursuant to Section 482, the Commissioner determined that the sales income reported

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[2]Unless otherwise noted, all references to the Code are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax periods in issue.

by the Alphabets and Foster Enterprises should be reallocated to petitioners' partnership (Pet. App. III, at 56, 102). That adjustment led to an increase in petitioners' gross income, since the income of a partnership flows through to its partners in accord with their respective distributive shares. Sections 701, 702. By reason of that adjustment, the Commissioner asserted deficiencies in petitioners' income taxes.

b. The partnership borrowed $3 million from a bank to finance the development of Foster City (Pet. App. II, at 21-22). Because the project was considered risky, the partnership agreed to pay the bank a bonus of $3 million for making the loan (*ibid.*). Through a convoluted series of transactions (the Westway transactions), the partnership endeavored to make its obligation to pay the bonus appear to produce a $3 million step-up in its basis in Neighborhoods Two and Three of Foster City (Pet. App. II, at 21-23; Pet. App. III, at 84-97). The gist of the transactions was that the partnership purported to sell 200 acres in Foster City to the bank for $105,000, and to buy them back, less than two years later, for $5,000 in cash plus $3.1 million in notes (*ibid.*). When the partnership thereafter sold the properties in Neighborhoods Two and Three to builders, it applied the claimed increase in basis to reduce the gain it reported on its tax returns (Pet. App. III, at 83). The Commissioner disallowed the accession to basis and determined income tax deficiencies, finding that the Westway transactions had "no business substance" (*ibid.*).

2. The Tax Court upheld the Commissioner's determinations on both counts. To begin with, the court found that the Commissioner's allocation of sales income to the partnership was within his discretion under Section 482 (Pet. App. III, at 172-184). The court found that the partnership conveyed the lots to the controlled corporations solely to avoid federal income taxes, not for any business reason

(*ibid.*). According to the Tax Court, the partnership was the "true earner" of the income, having "work[ed] day in and day out to effect the transformation of the land" (*id.* at 174), whereas petitioners' corporations "had not played any role in [Foster City's] development" (*id.* at 179). In the court's view, the transfers of "highly appreciated inventory pregnant with income" unquestionably "distorted the income[ ] of the Foster partnership" (*ibid.*).

Second, the Tax Court agreed with the Commissioner that "the substance of the Westway transaction [was] very different from its form" (Pet. App. III, at 201). The court found that the bonus owed by the partnership reflected additional interest on borrowed money, and was not part of the partnership's basis or investment in any property that it owned (*id.* at 200-211).

The court of appeals affirmed those holdings. First, the court agreed with the Tax Court that "[t]he transfers [among the controlled entities] had no business function; their purpose was tax avoidance" (Pet. App. II, at 21). The purpose of the transfers, the Ninth Circuit pointed out, was "to reduce income on [the partners'] personal tax returns" (*id.* at 10), and "to shift [the income] to Foster Enterprises * * * so that it could be absorbed by that corporation's losses" (*id.* at 14).

Like the Tax Court, the court of appeals also rejected petitioners' claim to a step-up in basis (Pet. App. II, at 21-29). The Westway transactions, the Ninth Circuit observed, were carried out "for the purpose of disguising the agreed upon bonus" as a capital transaction (*id.* at 26). Adopting the Tax Court's findings, the court of appeals concluded that the bonus constituted interest, *i.e.*, " 'the amount [the debtor] contracted to pay for the use of borrowed money' " (*id.* at 27, quoting *Old Colony R.R.* v. *Commissioner*, 284 U.S. 552, 560 (1932)).

3. The decision below is correct. The disposition of the fact-bound issues in this case by both courts below presents nothing that merits further review.

a. Its legislative history shows that Section 482 is designed to prevent distortion of the "true tax liability" of commonly controlled enterprises by "the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking' " (H.R. Rep. 2, 70th Cong., lst Sess. 16-17 (1927)). Long-standing Treasury Regulation provides that "[t]ransactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes" (Treas. Reg. § 1.482-1(c)). Under the Regulation, "[t]he standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer" (Treas. Reg. § 1.482-1(b)(1)).

Section 482 is intended, moreover, to "provid[e] a more appropriate manner of allocating income and deductions when the application of the general rules of the statute will not clearly reflect the true income." *National Securities Corp.* v. *Commissioner,* 137 F.2d 600, 602 (3d Cir.), cert. denied, 320 U.S. 794 (1943). Thus, the Regulation specifies that "Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such as section 351) providing for nonrecognition of gain or loss" (Treas. Reg. § 1.482-1(d)(5)).

The courts of appeals have regularly sustained the Commissioner's authority to apply Section 482 in the context of nonrecognition transactions. In *Rooney* v. *United States,* 305 F.2d 681 (9th Cir. 1962), a sole proprietor conveyed his farm to a corporation in exchange for all the stock (a Section 351 transaction), not long before the crops were

harvested. The court of appeals approved the Commissioner's allocation of the crop expenses to the corporation formed "in midstream," so that the deductions of the business would be matched with its income. In *National Securities Corp.* v. *Commissioner, supra,* a parent transferred to its subsidiary, in exchange for the latter's stock, a portfolio of securities that "had become well nigh valueless" (137 F.2d at 602). The court of appeals found that "[t]he shifting of the loss to the subsidiary g[ave] an artificial picture of its true income and one which it was unnecessary for the Commissioner to accept" (*id.* at 603). Accord, *Stewart* v. *Commissioner,* 714 F.2d 977, 989 (9th Cir. 1983).

b. The Commissioner's exercise of his authority here was equally "necessary in order to prevent evasion of taxes or clearly to reflect the income" (Section 482). The courts below agreed that the transfers among petitioners' controlled entities "had no business function" (Pet. App. II, at 21). Rather, "their purpose was tax avoidance" (*ibid.*). The property conveyed, the trial court found, was "highly appreciated inventory pregnant with income," income that "was not earned by Foster Enterprises [or by the Alphabets] but rather was completely earned by the Foster partnership" (Pet. App. III, at 178-179). Whereas the partnership "solv[ed] the major engineering problem related to the reclamation of the land," and "work[ed] day in and day out to effect the transformation of the land" (*id.* at 174), the controlled corporations performed nothing of substance to develop the properties (*id.* at 171-172, 173-174, 178-179). Thus, the scheme, pursuant to which the Alphabets and Foster Enterprises purportedly realized the income incident to sale of the lots, as the Tax Court concluded, "distorted the income[ ] of the Foster partnership" (*id.* at 179).

c. Contrary to petitioners' contention (Pet. 30-35), moreover, the decision below does not conflict with *Commissioner* v. *First Security Bank,* 405 U.S. 394 (1972). As this

Court later explained, "[w]e held there that the Commissioner could not properly allocate income to one of a controlled group of corporations under 26 U.S.C. § 482 where that corporation could not have received that income as a matter of law." *United States* v. *Basye*, 410 U.S. 441, 453 n.13 (1973). That is not the situation here, for petitioners' partnership could have, if it chose, retained title to the properties, sold them itself, and received the income, all without legal impediment.

Nor is there any conflict between the decision below and *Keller* v. *Commissioner*, 723 F.2d 58 (10th Cir. 1983), aff'g 77 T.C. 1014 (1981). That case involved a physician who assigned his earnings to his wholly-owned professional corporation. The Tax Court there rejected the Commissioner's use of Section 482 to tax the doctor on his corporation's receipts, finding that he dealt with his corporation at arm's length and that the amount of his compensation from the corporation (in the form of salary, pension, and other benefits) was essentially equivalent to the amount of income that he assigned to the corporation. 77 T.C. at 1025-1028. The *Keller* case has little to do with the instant case, where the partnership "divert[ed] what would normally be [its] income" to the controlled corporations (Pet. App. II, at 19-20) without receiving any commensurate financial return.

4. a. Under *Crane* v. *Commissioner*, 331 U.S. 1 (1947), when a taxpayer takes out a loan and applies the proceeds to buy property, he can, of course, generally include the amount of the loan in computing his basis in the property. The loan, in those circumstances, ordinarily forms part of "the cost of such property" within the meaning of Code Section 1012. The interest on the loan, however, is not so includible in basis. The interest simply reflects "the amount [the debtor] contracted to pay for the use of borrowed

money" (*Old Colony R.R.* v. *Commissioner*, 284 U.S. 552, 560 (1932)).

b. The courts below correctly applied these well-settled principles to the facts of the Westway transactions. Looking through the form of those transactions to their substance, the court of appeals agreed with the Tax Court that the $3 million bonus "represented an obligation by the Partnership to pay interest on the money borrowed" (Pet. App. II, at 23). Like the Tax Court, the court of appeals found that the Westway transactions were not made at arm's length, and were contrived and executed "for the purpose of disguising the agreed upon bonus" as capital gain (Pet. App. II, at 24, 26). In affirming the denial of petitioners' claim to a stepped-up basis, the court of appeals concluded that the bonus was not "part of the cost of the property" but rather part of "the cost of the loan" (*id.* at 29).

c. Contrary to petitioners' argument (Pet. 42), there is no conflict between the decision below and *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (1972). In that case, a borrower was required to buy stock in a bank as a condition of securing a loan. This Court held that, since the stock was a capital asset with long-term value, the amounts the borrower paid for the stock did not constitute interest. The situation in the instant case is materially different. In return for the bonus, petitioners received nothing from the bank besides a loan.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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